



**ORTHOPAEDIC HOSPITAL AND  
LOS ANGELES ORTHOPAEDIC  
HOSPITAL FOUNDATION**

Combined Financial Statements

October 31, 2008 and 2007

(With Independent Auditors' Report Thereon)



KPMG LLP  
Suite 2000  
355 South Grand Avenue  
Los Angeles, CA 90071-1568

## Independent Auditors' Report

The Board of Directors of Orthopaedic Hospital  
and the Board of Trustees of  
Los Angeles Orthopaedic Hospital Foundation:

We have audited the accompanying combined balance sheets of Orthopaedic Hospital and Los Angeles Orthopaedic Hospital Foundation as of October 31, 2008 and 2007, and the related combined statements of operations, changes in net assets, and cash flows for the years then ended. These combined financial statements are the responsibility of Orthopaedic Hospital and Los Angeles Orthopaedic Hospital Foundation's managements. Our responsibility is to express an opinion on these combined financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in the *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Orthopaedic Hospital and Los Angeles Orthopaedic Hospital Foundation's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the financial position of Orthopaedic Hospital and Los Angeles Orthopaedic Hospital Foundation as of October 31, 2008 and 2007, and the results of their operations, their changes in net assets, and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 26, 2009 on our consideration of Orthopaedic Hospital and Los Angeles Orthopaedic Hospital Foundation's internal control over financial reporting and our tests of their compliance with certain provisions of laws, regulations, contracts, grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

KPMG LLP

February 26, 2009

**ORTHOPAEDIC HOSPITAL AND  
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Combined Balance Sheets

October 31, 2008 and 2007

(Dollars in thousands)

Assets	2008	2007
Current assets:		
Cash and cash equivalents	\$ 4,342	4,351
Short-term investments (note 5)	4,985	7,523
Assets whose use is limited or restricted, current (note 5)	592	299
Patient accounts receivable, net of allowance for uncollectible accounts of \$243 in 2008 and \$211 in 2007 (notes 3 and 13)	1,836	1,544
Grants receivable	5,703	5,685
Other receivables	2,594	1,532
Other current assets	390	703
Total current assets	20,442	21,637
Assets whose use is limited or restricted (note 5)	86,781	119,824
Investments (note 5)	70,896	111,933
Property and equipment, net (note 6)	57,274	55,026
Deferred financing costs, net of accumulated amortization of \$1,572 in 2008 and \$1,397 in 2007	2,324	2,499
Other assets (note 10(b))	37,424	39,170
Total assets	\$ 275,141	350,089
<b>Liabilities and Net Assets</b>		
Current liabilities:		
Current portion of long-term debt (note 7)	\$ 1,255	1,195
Accounts payable and accrued expenses	3,640	4,433
Accrued compensation and related liabilities	303	234
Interest payable (note 7)	1,174	1,197
Payable to University of California at Los Angeles (note 10(b))	5,685	5,685
Estimated liability for self-insurance programs (notes 10(a) and 11)	327	414
Total current liabilities	12,384	13,158
Estimated liability for self-insurance programs (notes 10(a) and 11)	1,144	1,194
Long-term debt (note 7)	49,321	50,578
Other liabilities (notes 9(b) and 10(c))	5,532	5,456
Total liabilities	68,381	70,386
Net assets:		
Unrestricted:		
Board designated	40,963	58,290
Other	123,000	164,446
	163,963	222,736
Temporarily restricted (note 8)	18,311	28,431
Permanently restricted (note 8)	24,486	28,536
Total net assets	206,760	279,703
Commitments and contingencies (notes 10 and 11)		
Total liabilities and net assets	\$ 275,141	350,089

See accompanying notes to combined financial statements.

**ORTHOPAEDIC HOSPITAL AND  
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Combined Statements of Operations  
Years ended October 31, 2008 and 2007  
(Dollars in thousands)

	<u>2008</u>	<u>2007</u>
Operating revenue and support:		
Net patient service revenue (notes 3, 4, and 7)	\$ 12,026	8,025
Unrestricted gifts and bequests (note 12)	2,623	2,127
Research grants	2,742	2,334
Other operating revenue	2,051	2,783
Net assets released from restrictions used for operations	5,114	3,122
Total operating revenue and support	<u>24,556</u>	<u>18,391</u>
Operating expenses:		
Salaries and benefits (note 9)	9,034	9,222
Supplies and other expenses	12,037	8,503
Professional fees	1,900	2,782
Research	3,727	3,532
Marketing and communications	1,041	974
Community outreach	287	244
Insurance	231	123
Bad debt recoveries, net	(142)	(299)
Depreciation and amortization	3,032	1,510
Interest expense	3,593	1,799
Total operating expenses	<u>34,740</u>	<u>28,390</u>
Loss from operations before gain on sale of properties	(10,184)	(9,999)
Gain on sale of properties	<u>—</u>	<u>14</u>
Loss from operations	(10,184)	(9,985)
Nonoperating gains (loss):		
Investment (loss) income, net (note 5)	(48,730)	37,867
Other	432	200
Revenues and gains (less than) in excess of expenses and losses	(58,482)	28,082
Unrealized losses on endowments (note 5)	(1,029)	—
Net assets released from restrictions used for capital expenditures	738	2,740
Reclassification of investment portfolio to trading (note 5)	—	(21,923)
Change in net unrealized gains on other-than-trading investments	—	7,469
(Decrease) increase in unrestricted net assets	<u>\$ (58,773)</u>	<u>16,368</u>

See accompanying notes to combined financial statements.

**ORTHOPAEDIC HOSPITAL AND  
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Combined Statements of Changes in Net Assets  
Years ended October 31, 2008 and 2007  
(Dollars in thousands)

	Unrestricted			Temporarily restricted	Permanently restricted	Total
	Board designated	Other	Total			
Net assets at October 31, 2006	\$ 53,191	153,177	206,368	25,694	26,965	259,027
Revenues and gains in excess of expenses and losses	2,667	25,415	28,082	—	—	28,082
Reclassification of investment portfolio to trading (note 5)	—	(21,923)	(21,923)	—	—	(21,923)
Change in net unrealized gains on other-than-trading investments	2,432	5,037	7,469	624	—	8,093
Restricted gifts and bequests (note 12)	—	—	—	5,317	125	5,442
Investment income on permanently restricted net assets whose use is temporarily restricted	—	—	—	1,155	—	1,155
Change in value of split-interest agreements	—	—	—	1,503	1,446	2,949
Net assets released from restrictions used for: Capital expenditures	—	2,740	2,740	(2,740)	—	—
Operations	—	—	—	(3,122)	—	(3,122)
Increase in net assets for the year ended October 31, 2007	5,099	11,269	16,368	2,737	1,571	20,676
Net assets at October 31, 2007	58,290	164,446	222,736	28,431	28,536	279,703
Revenues and gains less than expenses and losses	(17,327)	(41,155)	(58,482)	—	—	(58,482)
Change in net unrealized losses on investments	—	—	—	(2,744)	—	(2,744)
Restricted gifts and bequests (note 12)	—	—	—	2,658	2	2,660
Investment loss on permanently restricted net assets whose use is temporarily restricted	—	—	—	(717)	—	(717)
Unrealized losses on endowments	—	(1,029)	(1,029)	—	—	(1,029)
Change in value of split-interest agreements	—	—	—	(3,732)	(3,785)	(7,517)
Net assets released from restrictions used for: Capital expenditures	—	738	738	(471)	(267)	—
Operations	—	—	—	(5,114)	—	(5,114)
Decrease in net assets for the year ended October 31, 2008	(17,327)	(41,446)	(58,773)	(10,120)	(4,050)	(72,943)
Net assets at October 31, 2008	\$ 40,963	123,000	163,963	18,311	24,486	206,760

See accompanying notes to combined financial statements.

**ORTHOPAEDIC HOSPITAL AND  
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Combined Statements of Cash Flows  
Years ended October 31, 2008 and 2007  
(Dollars in thousands)

	2008	2007
Cash flows from operating activities and nonoperating gains (losses):		
(Decrease) increase in net assets	\$ (72,943)	20,676
Adjustments to reconcile (decrease) increase in net assets to net cash used in operating activities and nonoperating gains (losses):		
Restricted contributions and investment income received	(689)	(5,567)
Net realized and unrealized losses (gains) on investments	55,641	(18,833)
Unrealized losses on endowments	1,029	—
Change in value of split-interest agreements	7,517	(2,949)
Depreciation and amortization	3,032	1,510
Gain on sale of property	—	(14)
Amortization of discount and premium, net	(2)	(2)
Amortization of deferred financing costs	175	179
Accretion of asset retirement obligation	109	109
Bad debt recoveries, net	(142)	(299)
Changes in operating assets:		
Patient accounts receivable	(150)	593
Grants receivable	(18)	(225)
Other receivables	(1,062)	121
Other current assets	313	345
Changes in operating liabilities:		
Accounts payable and accrued expenses	393	(655)
Accrued compensation and related liabilities	69	(52)
Estimated liability for self-insurance programs	(137)	(285)
Interest payable	(23)	(49)
Other liabilities	23	63
Net cash used in operating activities and nonoperating gains (losses)	(6,865)	(5,334)
Cash flows from investing activities:		
Purchase of investments	(25,211)	(110,751)
Proceeds from sales and maturity of investments	37,370	121,735
Other assets	338	(1,854)
Capital expenditures	(5,058)	(5,591)
Net cash provided by investing activities	7,439	3,539
Cash flows from financing activities:		
Change in liability for split-interest agreements	(53)	(18)
Change in liability for assets held for others	(3)	215
Proceeds from restricted contributions and restricted investment income	668	3,078
Principal payment on long-term debt	(1,195)	(1,140)
Receivable from FEMA	—	985
Net cash (used in) provided by financing activities	(583)	3,120
Net (decrease) increase in cash and cash equivalents	(9)	1,325
Cash and cash equivalents at beginning of year	4,351	3,026
Cash and cash equivalents at end of year	\$ 4,342	4,351
Supplemental disclosures of noncash investing and financing activities:		
Change in value of split-interest agreements	\$ 7,517	2,949
Supplemental disclosure of cash paid during the year for interest	\$ 2,879	2,936

See accompanying notes to combined financial statements.

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October 31, 2008 and 2007

**(1) Combined Financial Statements**

Orthopaedic Hospital (OH) and Los Angeles Orthopaedic Hospital Foundation (LAOHF) have presented their financial statements on a combined basis solely to comply with the presentation requirements set forth in the AICPA Audit and Accounting Guide for Health Care Organizations issued on June 1, 1996, as amended. All significant transactions between OH and LAOHF have been eliminated in the combined financial statements.

OH is a separate nonprofit corporation exempt from federal income and state franchise taxes. During the year ended October 31, 2005, OH opened a new 36,000 square-foot outpatient medical center (the Outpatient Center) on its premises, designed to more efficiently meet the needs of children with orthopedic disorders. OH continues to operate its 110,000 square-foot Lowman Outpatient Center on the downtown campus.

Through July 2005, OH operated a 112-bed acute care hospital specializing in the treatment of orthopaedic disorders in downtown Los Angeles. As more fully discussed in note 10(b), on June 30, 1998, OH entered into a strategic alliance (the Alliance) with the Regents of University of California (Regents) acting on behalf of the University of California Los Angeles (UCLA) campus to construct and renovate a facility to be known as the Santa Monica-UCLA Medical Center and Orthopaedic Hospital (SM-UCLA MC & OH) in Santa Monica, California, on land owned by UCLA. In exchange for its monetary contribution, OH received a 34% co-tenancy interest in the SM-UCLA MC & OH facility. This arrangement relieved OH of financial responsibility for an inpatient hospital facility. In return, UCLA is entitled to all hospital revenue generated by SM-UCLA MC & OH. In July 2005, OH transferred the inpatient hospital operations to the existing SM-UCLA MC & OH. Construction and renovation of the new SM-UCLA MC & OH facility, including construction of a new Orthopaedic Hospital wing portion of the hospital, is expected to be completed in 2010.

As a result of the transfer of OH's inpatient hospital operations, OH's board of directors and LAOHF's board of trustees approved a plan in March 2005 to sell its North Campus. The North Campus consisted of the hospital building, power plant, two medical office buildings, and the physical therapy building. OH sold the North Campus to a third party on July 18, 2006. OH retained the South Campus consisting of the new clinic building, the Lowman Building, various ancillary buildings, and space for a park for children with disabilities.

LAOHF is a separate nonprofit corporation exempt from federal and state franchise taxes. LAOHF solicits funds, which are used to support OH for charity care, medical research, education, and the purchase of related capital assets. Although LAOHF holds title to the real property used by OH, LAOHF is not involved in OH's patient, healthcare, or facilities management operations.

**(2) Summary of Significant Accounting and Reporting Policies**

**(a) Principles of Combination**

The combined financial statements include the accounts of OH and LAOHF. All significant intercompany balances and transactions have been eliminated in combination.

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**(b) *Use of Estimates***

The preparation of the combined financial statements requires management of OH and LAOHF to make a number of estimates and assumptions relating to the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the combined financial statements and the reported amounts of revenues and expenses during the reporting period. Significant items subject to such estimates and assumptions include the carrying amount of property and equipment; valuation allowances for receivables; and liabilities for self-insured programs, split-interest agreements, and asset retirement obligations. Actual results could differ from those estimates.

**(c) *Cash Equivalents***

Cash equivalents of approximately \$190,000 and \$195,000 at October 31, 2008 and 2007, respectively, consist primarily of certificates of deposit and U.S. Treasury bills with an initial term of less than three months. For purposes of the combined statements of cash flows, OH and LAOHF consider all highly liquid debt instruments with original maturities of three months or less to be cash equivalents, excluding amounts whose use is limited by board or donor designation or other arrangements under trust agreements.

**(d) *Patient Accounts Receivable***

Patient accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is OH's best estimate of the amount of probable credit losses in OH's existing patient accounts receivable. OH determines the allowance based on historical write-off experience. OH reviews its allowance for doubtful accounts monthly. Past-due balances over 90 days and over a specified amount are reviewed individually for collectibility. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. OH does not have any off-balance-sheet credit exposure related to its patients.

**(e) *Investments***

On October 31, 2007, OH and LAOHF changed the classification of their investments in debt and equity securities with readily determinable fair values to trading, including such investments classified as assets whose use is limited or restricted. Prior to October 31, 2007, these investments had been considered other-than-trading. As of October 31, 2008 and 2007, all investments are considered trading, with the exception of alternative investments which are considered other-than-trading.

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value based on quoted market prices in the combined balance sheets. Alternative investments are measured at cost, subject to adjustment for other-than-temporary impairment. Alternative investments represent ownership interests in corporations and a private fund that OH and LAOHF do not have the ability to exercise significant influence or control over.



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Investment income or loss (including realized gains and losses on investments, interest, and dividends) is included in revenues and gains (less than) in excess of expenses and losses unless the income or loss is restricted by donor or by law, in which case the investment income or loss is recorded directly to temporarily or permanently restricted net assets. Prior to October 31, 2007, unrealized gains and losses on investments are excluded from revenues and gains (less than) in excess of expenses and losses. After the designation of debt and equity securities as trading on October 31, 2007, unrealized gains and losses are included within revenues and gains (less than) in excess of expenses and losses.

OH and LAOHF evaluate on an ongoing basis their other-than-trading investments to determine whether other-than-temporary impairments exist. When believed probable that the decline in an investment is other-than-temporary, the unrealized loss on the investment is included in revenues and gains (less than) in excess of expenses and losses, and a new cost basis for the security is established.

**(f) *Assets Whose Use is Limited or Restricted***

Assets whose use is limited or restricted include: (1) funds held by a trustee, which are legally restricted for bond reserve accounts; (2) investments set aside by OH's board of directors primarily for self-insurance programs and by the LAOHF's board of trustees for research programs over which the respective boards retain control and may at their discretion subsequently use for other purposes; (3) amounts restricted as to use by donors, including pledges receivable and LAOHF's beneficial interest in split-interest agreements and perpetual trusts; and (4) assets held in trust for others. Amounts required to meet current liabilities are classified as current assets.

**(g) *Property and Equipment***

Property and equipment are stated at cost. Depreciation is computed using the straight-line method and is provided over the estimated useful lives of the assets. The range of the estimated useful lives for buildings and fixed equipment is 10 to 40 years and for movable equipment is 3 to 20 years. Interest cost incurred on tax-exempt borrowed funds during the period of construction of capital assets (net of interest income earned on such funds) is capitalized as a component of the cost of constructing those assets. Property and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset.

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Gifts of long-lived assets such as land, buildings, or equipment are reported as unrestricted support and are excluded from the revenues and gains (less than) in excess of expenses and losses of unrestricted net assets. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support and are classified as assets whose use is limited or restricted. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service and classified as property and equipment.

OH and LAOHF account for asset retirement obligations in accordance with Financial Accounting Standards Board (FASB) Statement No. 143, *Accounting for Asset Retirement Obligations*, and Interpretation No. (FIN) 47, *Accounting for Conditional Asset Retirement Obligations*, and accrue for costs related to legal obligations to perform certain activities in connection with the retirement, disposal, or abandonment of assets. OH and LAOHF have identified asbestos abatement as an asset retirement obligation. Asbestos abatement is estimated based upon historical removal cost per square foot applied to assets identified requiring asbestos abatement.

**(h) *Deferred Financing Costs***

Deferred financing costs are amortized over the 30-year term of the bonds using the effective-interest method, which results in a level yield on the unpaid balance.

**(i) *Temporarily and Permanently Restricted Net Assets***

Temporarily restricted net assets are those whose use has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained in perpetuity.

**(j) *Revenues and Gains (Less Than) in Excess of Expenses and Losses***

The combined statements of operations include revenues and gains (less than) in excess of expenses and losses. Changes in unrestricted net assets, which are excluded from the revenues and gains (less than) in excess of expenses and losses, include unrealized losses on endowment funds in excess of temporarily restricted unrealized gains, net assets released from restrictions used for capital expenditures and, in 2007, the reclassification of the investment portfolio to trading and change in net unrealized gains on other-than-trading investments prior to the reclassification to trading on October 31, 2007.

**(k) *Net Patient Service Revenue***

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

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**(l) Charity Care**

OH provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. OH maintains records to identify and monitor the level of charity care it provides. Because OH does not pursue collection of amounts determined to qualify as charity care, they are not reported as net revenue. The records maintained include the amount of charges for services and supplies furnished under its charity care policy and equivalent service statistics.

**(m) Donor-Restricted Gifts**

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. Fair value is determined based on quoted market prices or estimates based on valuation techniques, such as discounting estimated future cash flows. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the combined statements of operations as net assets released from restrictions.

**(n) Income Taxes**

OH and LAOHF are separate legal not-for-profit organizations exempt from taxation under Section 501(c)(3) of the Internal Revenue Code and Section 23701d of the California Revenue and Taxation Code and are generally not subject to federal or state income taxes. However, OH and LAOHF are subject to income taxes on any net income that is derived from a trade or business, regularly carried on, and not in furtherance of the purposes for which they were granted exemption. No income tax provision has been recorded as the net income, if any, from any unrelated trade or business, in the opinion of management, is not material to the combined financial statements taken as a whole.

OH and LAOHF adopted the provisions of FIN 48, *Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109*, effective November 1, 2007. FIN 48 addresses the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a threshold of more likely than not for recognition of tax benefits of uncertain tax position taken or expected to be taken in a tax return. FIN 48 also provides related guidance on measurement, derecognition, classification, interest and penalties, and disclosure. OH and LAOHF's adoption of FIN 48 did not have a material impact on their combined financial statements.

**(o) Recently Issued Accounting Standards**

In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*. FASB Statement No. 157 defines fair value, establishes a framework for the measurement of fair value, and enhances disclosures about fair value measurements. The statement does not require any new fair value measures. The statement is effective for fair value measures already required or

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permitted by other standards for fiscal years beginning after November 15, 2007. OH and LAOHF are required to adopt FASB Statement No. 157 beginning on November 1, 2008. FASB Statement No. 157 is required to be applied prospectively, except for certain financial instruments. Any transition adjustment will be recognized as an adjustment to opening unrestricted net assets in the year of adoption. In November 2007, the FASB proposed a one-year deferral of FASB Statement No. 157's fair value measurement requirements for nonfinancial assets and liabilities that are not required or permitted to be measured at fair value on a recurring basis. The adoption of FASB Statement No. 157 is not expected to have a material effect on OH and LAOHF's combined financial statements.

In February 2007, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities — Including an amendment of FASB Statement No. 115*. FASB Statement No. 159 gives OH and LAOHF the irrevocable option to carry most financial assets and liabilities at fair value that are not currently required to be measured at fair value. If the fair value option is elected, changes in fair value would be recorded in earnings at each subsequent reporting date. FASB Statement No. 159 is effective for OH and LAOHF's 2009 fiscal year. OH and LAOHF will assess whether to elect the FASB Statement No. 159 fair value option for all eligible assets and liabilities acquired or modified on or after the adoption date.

Through September 30, 2007, OH and LAOHF's management and investment of donor-restricted endowment funds were subject to the provisions of the Uniform Management of Institutional Funds Act (UMIFA). In 2006, the Uniform Law Commission approved the model act, Uniform Prudent Management of Institutional Funds Act (UPMIFA), that serves as a guideline to states to use in enacting legislation. Among UPMIFA's most significant changes is the elimination of UMIFA's important concept of historic dollar value threshold, the amount below which an organization could not spend from the fund in favor of a more robust set of guidelines about what constitutes prudent spending. Effective January 1, 2009, the State of California (State) enacted UPMIFA, the provisions of which apply to funds existing on or established after that date. Based on their interpretation of the provisions of UPMIFA, OH and LAOHF have determined that retaining their existing policies regarding net asset classification of their donor-restricted endowment funds is appropriate as of October 31, 2008 based on accounting standards in effect. In August 2008, FASB Staff Position (FSP) No. FAS 117-1, *Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act and Enhanced Disclosures for All Endowment Funds*, was issued, and its guidance is effective for fiscal years ending after December 15, 2008. A key component of the FSP is a requirement to classify the portion of a donor-restricted endowment fund that is not classified as permanently restricted net assets as temporarily restricted net assets until appropriated for expenditure. OH and LAOHF do not believe this net asset reclassification will be operationally significant nor have a significant impact on debt covenants. Another key component of the FSP is a requirement for expanded disclosures for all endowment funds.

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**(p) Reclassifications**

Certain reclassifications were made to the prior year amounts to conform with the current year presentation.

**(3) Net Patient Service Revenue**

OH has agreements with third-party payors that provide for payments to OH at amounts different from its established rates. A summary of the payment arrangements with major third-party payors is as follows:

- *Medicare* – Rates for outpatient services vary according to the assignment of certain Ambulatory Payment Classifications.
- *Medi-Cal* – Outpatient services are reimbursed based upon a fee schedule.
- *Commercial Insurers* – OH has also entered into payment agreements with certain commercial insurance carriers and managed care organizations. The basis for payment to OH under these agreements includes discounts from established charges and reimbursement based upon fee schedules.

Gross and net patient service revenue for the years ended October 31 comprises the following:

	2008			2007		
	Gross revenue	Contractual adjustments	Net revenue	Gross revenue	Contractual adjustments	Net revenue
	(Dollars in thousands)					
Medicare	\$ 4,126	(1,159)	2,967	4,325	(1,908)	2,417
Medi-Cal/other state-funded government programs	12,620	(6,386)	6,234	12,619	(8,159)	4,460
Preferred provider organizations	3,127	(795)	2,332	2,326	(1,241)	1,085
Other	819	(326)	493	668	(605)	63
	<u>\$ 20,692</u>	<u>(8,666)</u>	<u>12,026</u>	<u>19,938</u>	<u>(11,913)</u>	<u>8,025</u>

**(4) Charity Care**

OH's primary emphasis on charity care is aimed at children with orthopaedic conditions; however, OH extends charity care to certain other patients requiring orthopaedic services and to indigent children in need of specialty services who qualify under OH's established medical and financial conditions.

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OH maintains records to identify and monitor the level of charity care it provides. These records include the amount of charges forgone for services furnished under its charity care policy and the number of patients to whom charity care is provided. The following information measures the level of charity care provided during the years ended October 31, 2008 and 2007 based on charges and patients served:

	<u>2008</u>	<u>2007</u>
	(Dollars in thousands)	
Charges forgone for services furnished under OH's charity care policy	\$ 5,620	6,347
Outpatient visits:		
Clinic visits	33,206	31,082
Outreach clinic visits	11,731	7,505
Pediatric urgent care visits	14,251	14,004
Total outpatient visits	59,188	52,591

**(5) Investments and Assets Whose Use is Limited or Restricted**

The composition of investments, including assets whose use is limited or restricted, at October 31 is set forth in the following table:

	<u>2008</u>	<u>2007</u>
	(Dollars in thousands)	
Stated at fair value:		
Cash and cash equivalents	\$ 1,091	2,413
Mutual funds	11,643	17,366
Common and preferred stocks	61,876	107,061
Corporate bonds	48,346	62,052
U.S. Treasury bonds	4,075	4,075
Real estate and other investments	369	391
Pledges and grants receivable, net	476	455
Trusts and estates receivable	480	2,539
Gift annuities and pooled income fund	451	567
Beneficial interest in split-interest agreements	11,725	14,821
Beneficial interest in perpetual trusts	11,680	15,465
	\$ 152,212	227,205

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	<u>2008</u>	<u>2007</u>
	(Dollars in thousands)	
Stated at cost or net realizable value:		
Alternative investments, at cost	\$ 10,804	12,118
Interest receivable	238	256
	<u>11,042</u>	<u>12,374</u>
Total investments and assets whose use is limited or restricted	163,254	239,579
Amounts classified as assets whose use is limited or restricted	(87,373)	(120,123)
Amounts classified as short-term investments	(4,985)	(7,523)
Long-term investments	<u>\$ 70,896</u>	<u>111,933</u>

In fiscal year 2008, OH and LAOHF recorded an other-than-temporary impairment of approximately \$1,492,000 related to their alternative investments, and a new cost basis was established. This decline is included as a component of investment (loss) income, net, within revenues and gains (less than) in excess of expenses and losses. Alternative investments, at cost, represent approximately 7% and 5% of total investments and assets whose use is limited or restricted at October 31, 2008 and 2007, respectively.

Based upon the valuations provided by investment managers of the alternative investments held by OH and LAOHF, the estimated fair value of the alternative investments was \$10,804,000 and \$13,660,000 at October 31, 2008 and 2007, respectively.

Assets whose use is limited or restricted at October 31 are as follows:

	<u>2008</u>	<u>2007</u>
	(Dollars in thousands)	
Held by trustee under bond indenture	\$ 4,103	4,288
Board designated for research programs	40,963	58,290
Restricted by donor for specific purposes	17,479	23,454
Pledges and grants receivable, net	233	455
Trusts and estates receivable	481	2,539
Beneficial interest in split-interest agreements	12,177	15,388
Beneficial interest in perpetual trusts	11,680	15,465
Assets held in trust for others	<u>257</u>	<u>244</u>
	87,373	120,123
Amounts required to pay current liabilities	(592)	(299)
	<u>\$ 86,781</u>	<u>119,824</u>



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Investment income for investments, assets whose use is limited or restricted, and cash equivalents reflected in unrestricted net assets comprise the following for the years ended October 31:

	<u>2008</u>	<u>2007</u>
	(Dollars in thousands)	
Nonoperating gains (loss):		
Interest income and dividends	\$ 3,450	5,204
Realized gains on securities, net	1,364	10,740
Holding (loss) gain on trading portfolio	(52,052)	21,923
Other-than-temporary impairment on alternative investments	(1,492)	—
	<u>(48,730)</u>	<u>37,867</u>
Other changes in unrestricted net assets:		
Unrealized losses on endowments	(1,029)	—
Changes in net unrealized gains on other-than-trading investments	—	7,469
Reclassification of investment portfolio to trading	—	(21,923)
Total investment return	<u>\$ (49,759)</u>	<u>23,413</u>

The effect of the change in classification of investments to trading in 2007 resulted in \$21,923,000 of net unrealized gains being reclassified to nonoperating gains (losses) at October 31, 2007, representing the difference between cost and fair value of investments at October 31, 2007.

**(6) Property and Equipment**

Property and equipment as of October 31 are summarized as follows:

	<u>2008</u>	<u>2007</u>
	(Dollars in thousands)	
Land	\$ 441	441
Land improvements	2,808	392
Buildings and fixed equipment	27,307	22,735
Movable equipment	9,211	7,983
	<u>39,767</u>	<u>31,551</u>
Accumulated depreciation	<u>(17,617)</u>	<u>(16,141)</u>
	22,150	15,410
Construction in progress	35,124	39,616
	<u>\$ 57,274</u>	<u>55,026</u>



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**(7) Long-Term Debt**

The following is a summary of long-term debt at October 31:

	<u>2008</u>	<u>2007</u>
	(Dollars in thousands)	
California Statewide Communities Development Authority		
Certificates of Participation	\$ 50,550	51,745
Unamortized original issue discount	(68)	(73)
Unamortized original issue premium	94	101
	<u>50,576</u>	<u>51,773</u>
Less current portion	<u>(1,255)</u>	<u>(1,195)</u>
	<u>\$ 49,321</u>	<u>50,578</u>

On July 11, 2000, OH issued Certificates of Participation (Certificates) totaling \$55,000,000. The Certificates consist of \$24,655,000 serial certificates due in varying installments commencing June 1, 2005 and continuing until June 1, 2020, and term certificates of \$30,345,000 due June 1, 2030. The term certificates require annual mandatory sinking fund payments prior to maturity in varying installments commencing June 1, 2021. The Certificates have a stated interest rate ranging from 5.00% to 5.75%. Interest on the Certificates is payable semiannually. The underwriters' discount and other costs of issuance totaled approximately \$3,786,000 for the Certificates, of which approximately \$1,572,000 and \$1,397,000 was amortized as of October 31, 2008 and 2007, respectively.

OH is currently servicing the Certificates, and accordingly, the debt has been recorded by OH. LAOHF, as co-obligor, is jointly liable under the indenture agreement. The Certificates are secured by the pledge of gross revenues of OH and LAOHF and by a deed of trust of their real property located in Los Angeles, California. During 2006, OH and LAOHF received a release from the bond insurer for the property that was sold. As a result of the approval, OH and LAOHF are required to utilize \$5 million of the proceeds from the sale to reduce the bonds outstanding. Repayment is required by December 31, 2009.

Under the terms of the bond indenture, OH is required to place its construction funds and bond fund reserves with a trustee. Such funds are included with assets whose use is limited or restricted and amount to approximately \$4,103,000 and \$4,288,000 as of October 31, 2008 and 2007, respectively. The bond indenture also places limits on the incurrence of additional borrowings by requiring that OH satisfy certain measures of financial performance as long as the bonds are outstanding.

Beginning October 31, 2004, the loan agreement requires OH and LAOHF to meet a debt service coverage ratio. OH and LAOHF were unable to meet the debt service coverage ratio at October 31, 2004, and as a result, management negotiated revised covenant terms with the bond insurer effective March 1, 2005. Under the revised covenant terms, the bond insurer waived OH and LAOHF's compliance with the debt service coverage ratio through October 31, 2005. The bond insurer also prospectively waived compliance with the debt service coverage ratio, provided certain interim covenants are met through the waiver period,

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defined as November 1, 2005 through October 31, 2008. Interim covenants required to be met throughout the waiver period include the maintenance of an operations reserve equal to \$50 million and certain other financial covenants. The agreement also requires OH and LAOHF to meet certain additional permanent covenants that will continue to be imposed after the termination of the waiver period. OH and LAOHF met the interim covenants and additional permanent covenants during the waiver period, except for the permanent covenant requirement on debt service coverage ratio. On January 6, 2009, the bond insurer waived the debt service coverage ratio for fiscal years 2008 and 2009.

Certificates maturing on or after June 1, 2008 are subject to redemption prior to their respective stated maturity, at the option of the California Statewide Communities Development Authority upon direction of OH and LAOHF, as a whole or in part. Certificates maturing on June 1, 2030 are subject to redemption, prior to their maturity, in part, by lot, from mandatory sinking account payments deposited in the bond fund pursuant to the indenture agreement.

Based on the borrowing rate currently available to OH and LAOHF for loans with similar terms and maturities, the estimated fair value of long-term debt was approximately \$44,283,000 and \$52,040,000 at October 31, 2008 and 2007, respectively.

The proceeds of the Certificates have been utilized to: (a) finance a portion of the cost of a research facility being constructed at UCLA main campus (see note 10(b)); (b) finance a portion of the cost of constructing, rehabilitating, and equipping portions of OH's downtown campus; (c) fund a debt service reserve fund for the Certificates; (d) fund working capital; (e) fund capitalized interest; and (f) pay certain costs of issuance of the Certificates.

Scheduled principal payments on long-term debt as of October 31, 2008 are as follows (dollars in thousands):

2009	\$	1,255
2010		6,320
2011		1,390
2012		1,460
2013		1,530
2014 and thereafter		38,595
	\$	<u>50,550</u>

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A summary of interest cost and investment income capitalized on borrowed funds held by the trustee under the 2000 bond indenture during the years ended October 31, 2008 and 2007 is as follows:

	<u>2008</u>	<u>2007</u>
	(Dollars in thousands)	
Interest cost:		
Capitalized	\$ —	1,391
Charged to operations	3,484	1,689
	<u>\$ 3,484</u>	<u>3,080</u>
Investment income:		
Capitalized	\$ —	148
Credited to investment income	69	77
	<u>\$ 69</u>	<u>225</u>

**(8) Temporarily and Permanently Restricted Net Assets**

Temporarily restricted net assets, exclusive of cumulative net unrealized gains of approximately \$0 and \$2,750,000 at October 31, 2008 and 2007, respectively, are available for the following purposes:

	<u>2008</u>	<u>2007</u>
	(Dollars in thousands)	
Healthcare services:		
Operations – restricted as to time	\$ 5,955	7,492
Purchase of equipment	714	512
Pediatric indigent care	7,196	11,534
Health education	3,463	5,541
Research	983	602
	<u>\$ 18,311</u>	<u>25,681</u>
Permanently restricted net assets are restricted to investments to be held in perpetuity, the income from which is expendable to support specific healthcare services (reported as temporarily restricted net assets)	\$ 24,486	28,536

Due to the significant decline in investment returns during fiscal year 2008, OH and LAOHF experienced net unrealized losses on investments to be held in perpetuity, the income from which is reported as temporarily restricted net assets. Such losses totaling \$1,728,000 for the year ended October 31, 2008 exceeded cumulative unrealized gains by \$1,029,000, resulting in a charge below revenue and gains (less than) in excess of expenses and losses of \$1,029,000 for the year ended October 31, 2008. Such losses will continue to be recorded as changes in unrestricted net assets until such time as the cumulative losses have been recovered.

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**(9) Employee Benefit Plans**

**(a) Pension Plan**

OH has a 401(k) defined contribution plan (Plan). Employees are eligible to participate in the Plan after one year of service in which they have completed 12 months of service. OH makes matching contributions to the Plan of 50% of the first 6% of compensation. Additionally, OH makes a 3% contribution based on a participant's compensation. Included in salaries and benefits expense are employer contributions to the Plan of approximately \$330,000 and \$327,000 for the years ended October 31, 2008 and 2007, respectively.

**(b) Defined Benefit Supplemental Executive Retirement Plan**

OH has a defined benefit supplemental executive retirement plan, which includes benefits for a key executive in excess of qualified plan limitations. For the years ended October 31, 2008 and 2007, net retirement expense for this plan totaled approximately \$101,000 and \$42,000, respectively. During April 2006, the executive was fully vested and became eligible for monthly benefit payments commencing May 1, 2006. In accordance with the terms of the plan agreement, the executive opted to receive a lump-sum payment of approximately \$1.2 million, with the remainder to be received in equal installment payments of approximately \$7,000 starting May 1, 2006 for 163 months or 13.58 years. Measurement of the plan obligation is calculated as of October 31 of each year. The discount rate used to determine the actuarial present value of the projected benefit obligation was 4.01% and 4.74% as of October 31, 2008 and 2007, respectively. The accumulated benefit obligation, included in other liabilities in the combined balance sheets, totaled approximately \$1,123,000 and \$1,111,000 as of October 31, 2008 and 2007, respectively. The benefits provided by OH under this plan are not intended to constitute a pension plan, and such benefits are not required to be secured or funded by OH in any manner. Amounts payable by OH under this plan are payable solely from the general assets of OH and LAOHF.

**(10) Commitments and Contingencies**

**(a) Self-Insurance Program**

Prior to August 1, 2007, OH elected to self-insure its statutory obligation for workers' compensation benefits. Under this program, OH is responsible for workers' compensation benefits of up to \$750,000 per accident in any fiscal year. OH is reinsured with stop-loss coverage for workers' compensation claims up to an annual limit of \$25 million. OH management believes that costs, including costs for claims incurred but not reported, have been adequately provided for in the combined financial statements.

Effective August 1, 2007, OH obtained occurrence-based insurance coverage for its workers' compensation benefits with statutory limit and employer's liability of \$1 million and \$0 deductible amount. Claims incurred prior to August 1, 2007 will continue to be covered under OH's self-insured workers' compensation plan.

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**(b) *UCLA Agreement***

As described in note 1, OH entered into an Alliance with the Regents to construct a facility to be known as the SM-UCLA MC & OH. As required by the Alliance, OH applied its \$30,000,000 grant from the Federal Emergency Management Agency (FEMA) and paid an additional \$3.4 million to UCLA to help with construction of the SM-UCLA MC & OH. In exchange for its monetary contribution, OH received a 34% co-tenancy interest in the SM-UCLA MC & OH facility. In July 2005, OH transferred the inpatient hospital operations to the existing SM-UCLA MC & OH. Construction and renovation of the new SM-UCLA MC & OH is expected to be completed in 2010. This arrangement relieved OH of financial responsibility for an inpatient hospital facility. In return, UCLA is entitled to all hospital revenue generated by SM-UCLA MC & OH. OH has recorded expenditures incurred in connection with the SM-UCLA MC & OH as construction in progress amounting to \$33,849,000 and \$33,835,000 as of October 31, 2008 and 2007, respectively.

In the event the Alliance terminates, UCLA must purchase OH's interest in SM-UCLA MC & OH for \$46,500,000, which amount is subject to increase based on an index reflecting the annual increase in construction costs and decrease based on straight-line depreciation of that amount over 30 years. Therefore, the asset will be depreciated over the 30-year term of the agreement once construction is complete, which is expected to occur in 2010.

OH also cumulatively paid \$30,000,000 (\$5,000,000 in November 2002 and \$25,000,000 in February 2003) to the Regents to help fund construction of a new research facility. Although the research building is owned entirely by the Regents, a combined OH/UCLA research program will occupy approximately 50% of the building at no occupancy cost to OH. Accordingly, OH has recorded the \$30 million, as well as capitalized interest specifically related to the construction, as prepaid rent, included in other assets in the accompanying combined financial statements, to be amortized over the 30-year term of the agreement upon occupancy of the research building by OH. The Orthopaedic Hospital Research Center opened in June 2007. OH recorded approximately \$1,408,000 and \$417,000 as amortization of prepaid rent in 2008 and 2007, respectively. OH will support the OH/UCLA researchers at OH's and LAOHF's current level of research support, net of research grants, in the range of \$1,000,000 to \$3,000,000 per year. OH will receive 25% of net revenue from intellectual property developed by the combined OH/UCLA researchers.

On June 1, 1998, UCLA appointed OH's CEO as Vice Chair of the newly renamed UCLA/Orthopaedic Hospital Department of Orthopedic Surgery. Effective March 1, 2007, UCLA appointed OH's CEO as Program Director for the newly renamed Orthopaedic Hospital/UCLA Residency Program. UCLA shall give OH's nominee significant representation on its hospital and medical school advisory boards. OH appointed two members nominated by UCLA to OH's board of directors and one member nominated by UCLA to LAOHF's board of trustees.

**(c) *Asset Retirement Obligation***

OH and LAOHF have identified asbestos abatement activities as a conditional asset retirement obligation. As of October 31, 2008 and 2007, amounts recorded totaled approximately \$3,032,000 and \$2,923,000, respectively, and are included in other liabilities in the accompanying combined

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balance sheets. The obligation is discounted utilizing a rate of 4.47% and is being accreted to expense until such point remediation costs are required, currently anticipated to occur in 2011. Accretion expense totaled \$109,000 for each of the years ended October 31, 2008 and 2007.

**(d) *Compliance with Laws and Regulations***

The healthcare industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, and Medi-Cal fraud and abuse. Government activity continues with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by healthcare providers. Violations of these laws and regulations could result in expulsion from government healthcare programs, together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed and collected. Management believes that the Company is in compliance with applicable fraud and abuse regulations, as well as other applicable government laws and regulations. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time.

**(11) Malpractice**

OH is a defendant in various legal actions alleging malpractice and other matters arising from the normal course of business. Liability insurance has been maintained to protect OH's assets from monetary judgments resulting from such actions. It is OH management's opinion that these matters are covered by insurance and will be disposed of without a material adverse effect on the accompanying combined financial statements.

Prior to September 1, 2003, OH maintained commercial malpractice liability insurance coverage under various modified claims-made policies covering aggregate losses up to \$30,000,000 per year, with a per claim deductible of \$10,000. OH has accrued, in accordance with accounting principles generally accepted in the United States of America, a liability for incurred but not reported losses that may exist outside the policy period. Effective September 1, 2003, OH obtained an occurrence-based medical malpractice insurance policy covering claims that occur during the policy term regardless of when the claim is reported with an annual aggregate limit of \$20,000,000 and a per claim deductible of \$5,000. During August 2005, OH obtained a claims-made medical malpractice insurance policy, with an annual aggregate limit of \$10,000,000 and a per claim deduction of \$5,000. OH's management believes that costs, including cost for claims incurred but not reported, have been adequately provided for in the combined financial statements.

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**(12) Gifts and Bequests**

Gifts and bequests contributed to OH and LAOHF for the years ended October 31, 2008 and 2007 are from the following sources:

	<u>2008</u>	<u>2007</u>
	(Dollars in thousands)	
Estates	\$ 2,307	3,638
Trusts	760	867
Foundations	617	1,322
Corporations	233	159
Clubs and other organizations	275	7
Support groups	467	493
Individuals	624	1,083
	<u>5,283</u>	<u>7,569</u>
Restricted amount	(2,660)	(5,442)
Unrestricted amounts	<u>\$ 2,623</u>	<u>2,127</u>

**(13) Concentration of Credit Risk**

OH grants credit without collateral to patients, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors at October 31, 2008 and 2007 was as follows:

	<u>2008</u>	<u>2007</u>
Medicare	29%	35%
Medi-Cal/other state-funded government programs	53	48
Preferred provider organizations	13	16
Other third-party payors	3	1
Self-pay	2	—
	<u>100%</u>	<u>100%</u>

**(14) Fair Value of Financial Instruments**

OH and LAOHF estimate the fair value of each class of financial instrument as follows:

*Cash and cash equivalents, accounts receivable, other current assets, other assets, accounts payable and accrued expenses, interest payable, and other liabilities:* The carrying amounts approximate fair value.



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*Investments:* The fair values of debt securities and equity investments are based on quoted market prices at the reporting date for those or similar investments. The fair value of the alternative investments is based on valuations provided by the managers of the specific funds. The estimated value of alternative investments is subject to uncertainty because they are not readily marketable and, therefore, may differ from the value that would have been used had a market for such investments existed.

*Long-term debt:* The fair value of OH and LAOHF's long-term debt is estimated based on the quoted market prices for the same or similar issues or on the current rates offered to OH and LAOHF for debt of the same remaining maturities.

**(15) Functional Expenses**

OH provides general healthcare services to residents within its service area as well as medical education and research. LAOHF raises money for healthcare, education, and research. Expenses related to these activities at October 31, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
	(Dollars in thousands)	
Patient care and program expenses	\$ 20,820	15,587
General and administrative:		
Depreciation	363	567
Fund-raising	2,034	1,799
Insurance	200	123
Other	11,323	10,314
	<u>13,920</u>	<u>12,803</u>
	<u>\$ 34,740</u>	<u>28,390</u>

**(16) Subsequent Event**

OH derived approximately 52% and 56% of its net patient service revenue for the years ended October 31, 2008 and 2007, respectively, from Medi-Cal and other State funding sources. Due to delays in State funding for many programs as a result of State budget concerns, OH may experience delays in reimbursement for services provided to patients under Medi-Cal and other State-funded programs. OH and LAOHF believe that sufficient resources currently exist to meet their obligations, and that the impact of delays in reimbursement, if any, will not have a significant impact on their financial position, results of operations, or changes in net assets.





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**ORTHOPAEDIC HOSPITAL AND  
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KPMG LLP  
Suite 2000  
355 South Grand Avenue  
Los Angeles, CA 90071-1568

**Report on Internal Control over Financial Reporting and on Compliance and  
Other Matters Based on an Audit of Financial Statements  
Performed in Accordance with *Government Auditing Standards***

The Board of Directors of Orthopaedic Hospital and  
the Board of Trustees of Los Angeles Orthopaedic Hospital Foundation:

We have audited the combined financial statements of Orthopaedic Hospital and Los Angeles Orthopaedic Hospital Foundation (the Company) as of and for the year ended October 31, 2008, and have issued our report thereon dated February 26, 2009. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

**Internal Control over Financial Reporting**

In planning and performing our audit, we considered the Company's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the combined financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified a deficiency in internal control over financial reporting that we consider to be a significant deficiency.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control over financial reporting. We consider the deficiency described in the accompanying schedule of findings and questioned costs as item 2008-01 to be a significant deficiency in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be

material weaknesses. However, we do not believe that the significant deficiency described above is a material weakness.

### **Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Company's combined financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

The Company's response to the finding identified in our audit is described in the accompanying schedule of findings and questioned costs. We did not audit the Company's response, and accordingly, we express no opinion on it.

This report is intended solely for the information and use of the Company's board of directors and board of trustees, its audit committee, management, and its federal awarding agencies, and pass-through entities, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

February 26, 2009



KPMG LLP  
Suite 2000  
355 South Grand Avenue  
Los Angeles, CA 90071-1568

## **Report on Compliance with Requirements Applicable to the Major Program and on Internal Control over Compliance in Accordance with OMB Circular A-133**

The Board of Directors of Orthopaedic Hospital and  
the Board of Trustees of Los Angeles Orthopaedic Hospital Foundation:

### **Compliance**

We have audited the compliance of Orthopaedic Hospital and Los Angeles Orthopaedic Hospital Foundation (the Company) with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that are applicable to its major federal program for the year ended October 31, 2008. The Company's major federal program is identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to its major federal program is the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Company's compliance with those requirements and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on the Company's compliance with those requirements.

In our opinion, the Company complied, in all material respects, with the requirements referred to above that are applicable to its major federal program for the year ended October 31, 2008.

### **Internal Control over Compliance**

The management of the Company is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Company's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control over compliance.

A control deficiency in an entity's internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weaknesses is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control.

Our consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

#### **Schedule of Expenditures of Federal Awards**

We have audited the combined financial statements of the Company as of and for the year ended October 31, 2008, and have issued our report thereon dated February 26, 2009. Our audit was performed for the purpose of forming an opinion on the combined financial statements taken as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by the OMB Circular A-133 and is not a required part of the combined financial statements. Such information has been subjected to the auditing procedures applied in the audit of the combined financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the combined financial statements taken as a whole.

This report is intended solely for the information and use of the Company's board of directors and board of trustees, its audit committee, management, and federal awarding agencies and pass-through entities, and is not intended to be and should not be used by anyone other than these specified parties.

*KPMG LLP*

February 26, 2009

**ORTHOPAEDIC HOSPITAL AND  
LOS ANGELES ORTHOPAEDIC HOSPITAL FOUNDATION**

Schedule of Expenditures of Federal Awards

Year ended October 31, 2008

Federal grantor/pass-through grantor/program title	Catalog of federal domestic assistance number	Contract or pass-through number	Federal expenditures
U.S. Department of Health and Human Services: Health Resources and Services Administration	93.887	C76HF09415	\$ 17,491
Research and Development Cluster: National Institutes of Health National Heart, Lung, and Blood Institute: Biochemistry of Normal and Abnormal Variants of Factor IX	93.839	2R56 HL036365-21 2R01 HL036365-21A	349,345
Molecular Recognition of Factor VIIa Induced Coagulation	93.839	7 R01 HL070369-05	947
Safer Thrombolytic Therapy Using Plasmin	93.839	1 R01 HL074051-04	190,494
Total Research and Development Cluster			540,786
Total expenditures of federal awards			\$ 558,277

See accompanying notes to schedule of expenditures of federal awards and report on compliance with requirements applicable to the major program and internal control over compliance in accordance with OMB Circular A-133.

**ORTHOPAEDIC HOSPITAL AND  
LOS ANGELES ORTHOPAEDIC HOSPITAL FOUNDATION**

Notes to Schedule of Expenditures of Federal Awards

Year ended October 31, 2008

**(1) General**

The accompanying schedule of expenditures of federal awards presents the activity of all federal financial assistance programs of Orthopaedic Hospital and Los Angeles Orthopaedic Hospital Foundation (the Company).

**(2) Basis of Accounting**

The accompanying schedule is presented using the accrual basis of accounting, which is described in the notes to the combined financial statements of the Company as of and for the year ended October 31, 2008.

**(3) Relationship to Federal Financial Reports**

Amounts reported in the accompanying schedule agree with the amounts reported in the related federal financial reports in all material respects.



**ORTHOPAEDIC HOSPITAL AND  
LOS ANGELES ORTHOPAEDIC HOSPITAL FOUNDATION**

Schedule of Findings and Questioned Costs

Year ended October 31, 2008

**(1) Summary of Auditors' Results**

***Combined Financial Statements***

Type of Auditors' Report Issued:

Unqualified opinion.

Internal Control over Financial Reporting:

- Material weaknesses identified        Yes   X   No
- Significant deficiencies in internal control were disclosed  
by the audit of the combined financial statements   X   Yes        None reported
- Noncompliance Material to Financial Statements Noted        Yes   X   No

***Federal Awards***

Internal Control over Major Programs:

- Material weakness(es) identified        Yes   X   No
- Significant deficiencies in internal control over  
major program        Yes   X   None reported

Type of Auditor's Report Issued on Compliance  
for Major Programs:

Unqualified opinion.

Any Audit Findings that are Required  
to be Reported in Accordance with Section 510(a)  
of OMB Circular A-133

       Yes   X   No

Identification of Major Program:

<b>CFDA No.</b>	<b>Federal program name</b>
93.839	U.S. Department of Health and Human Services Research and Development Cluster: Biochemistry of Normal and Abnormal Variants of Factor IX Molecular Recognition of Factor VIIa Induced Coagulation Safer Thrombolytic Therapy using Plasmin

Dollar Threshold Used to Distinguish between  
Type A and Type B Programs:

\$300,000

Auditee Qualified as Low-Risk Auditee

  X   Yes        No

**ORTHOPAEDIC HOSPITAL AND  
LOS ANGELES ORTHOPAEDIC HOSPITAL FOUNDATION**

Schedule of Findings and Questioned Costs

Year ended October 31, 2008

**(2) Findings Relating to the Financial Statements Reported in Accordance with *Government Auditing Standards***

**Finding 2008-01 – Accounting for Donor Restricted Endowment Funds**

***Observation***

Permanently restricted net assets are restricted to investments to be held in perpetuity, the income from which is expendable to support specific healthcare services (reported as temporarily restricted net assets).

During our audit, we noted the Company erroneously recorded endowment fund losses incurred during fiscal 2008 of approximately \$1,728,000 as changes in permanently restricted net assets. Per Financial Accounting Standard Board Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, in the absence of donor stipulations or law to the contrary, losses on the investments of a donor-restricted endowment fund shall reduce temporarily restricted net assets to the extent that donor-imposed temporary restrictions on net appreciation of the fund have not been met before the loss occurs. Any remaining loss shall reduce unrestricted net assets.

***Recommendation***

We recommend management and accounting staff responsible for financial reporting review relevant accounting literature necessary for them to perform their functions accurately as it relates to accounting for donor restricted endowment funds. Consideration should also be given for accounting staff, as necessary, to attend training sessions to enhance their current knowledge of U.S. generally accepted accounting principles.

***Views of Responsible Officials and Planned Corrective Actions***

We have changed our process to include review of pertinent accounting literature before recording any transaction that is out of the ordinary.

**(3) Findings and Questioned Costs Relating to Federal Awards**

None.